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No. 88-1554

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1989

VINCENT E. DAVIS,

Petitioner,

vs.

HENRY HIMMELFARB; CHARLES T. HAYS; RICHARD A. EDWARDS; GOLDEN ARROW GAS ENERGY CORPORATION; JIM KITCHENS; RONALD G. MILLER; RUTAN & TUCKER; ROBERT PIKE; EMPIRE EQUITIES; RONALD GARRETT,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Is a secured note, the terms of which were negotiated by all parties to the transaction a security as defined by section 3(a) of the Securities & Exchange Act of 1934, 15 USC §78 (c)(a)?

2. Does a Federal District Court have discretion to dismiss state claims, whether ancillary or pendent, after the resolution of the federal claim?

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On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 858 F.2d 515 ("Danner, et al., v. Himmelfarb, et al. and related cross-actions", Pet. App. A 22-59 [1]/

[1] "Pet. App." refers to Petitioner's Appendix.

The memorandum opinion of the United States District Court for the Central District of California (Pet. App. A1-19) has not been officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on September 28, 1988. Petitioner's petition for rehearing was denied on December 15, 1988. (Pet. App. A60-61) The jurisdiction of the Court is invoked by Petitioner under 28 U.S.C. 1254(1).

STATEMENT OF THE CASE

By perceiving a departure from firmly

anchored securities precedent by the Court of Appeal, where no departure exists, Petitioner challenges a well thought out and reasoned opinion of the court. Until now, a party could not be held liable under federal securities law in relation to the issuance of a note which bears none of the long established characteristics of a security. The issue posed by Petitioner's application is whether these longstanding principles of securities law should be abrogated by holding a note a security by proving only the document itself. The facts of this case do not demonstrate a further refining of securities law in the area of the issuance of notes and the petition should be denied. Further, this Court has repeatedly recognized a federal court's wide latitude to decide ancillary or pending questions of state law. The state law claims were properly dismissed

after resolution of the federal questions in this action and for this reason the petition should be denied.

The statement of facts and proceedings below presented by Petitioner is adopted herein with the following corrections:

A. **Statement of Facts**

Petitioner has gone to great lengths to summarize the facts of this case from its inception. The summarization includes a number of extraneous facts and the Court's attention is respectfully directed to those facts which form the basis for the underlying procedural motions and subsequent hearing before the Court of Appeals.

During the latter part of 1982,

Empire Equities, INC. became interested in certain investment opportunities in Mexico. Due to the uncertainty of the monetary situation in that country, the directors of Empire decided to obtain peso holdings within Mexico through individuals for use as working capital.

In November 1982, Davis was informed by his daughter Leslie, an employee of Empire, that Empire was looking for pesos for use in connection with some of their Mexico operations. Davis, who had large holdings of Pesos within Mexico, told his daughter that he might be interested in discussing the transfer or selling of pesos to Empire. A meeting was subsequently arranged with Davis and certain principals of Empire to effectuate this transaction. Initially, the officers of Empire offered Davis oil and gas mineral interests in

exchange for his pesos. Davis declined this offer, as he later declined the opportunity to exchange his pesos for a share of the profits from the Mexican venture Empire was pursuing. Davis eventually negotiated to receive from Empire a promissory note in the principal sum of $400,000, payable in United States currency, with quarterly interest to be paid at an annual rate of prime plus one percent, with interest payments to commence in June 1984 in exchange for his pesos. Davis insisted that the note be secured by a first lien deed of trust. Empire agreed and granted Davis a lien on property in Oregon. Davis did not realize that this lien was subordinate to the liens of the original plaintiffs in this action (the Danners and Gadan, Inc. and an Oklahoma bank.)

B. **The Proceedings Below**

In February 1984 plaintiffs Danner and Gadan filed a suit to foreclose their deed of trust on the Oregon property. The suit was commenced in the United States District Court for the District of Oregon and Petitioner Davis was named as a defendant. Davis answered the plaintiff's complaint and cross-complained against his co-defendants Hays, Himmelfarb, Edwards and Empire. He alleged a securities law claim for fraud, as well as several state law claims. The court severed Davis' cross-claims for a separate trial. Himmelfarb moved for a transfer of the cross-claims to California. With leave of court, Petitioner Davis amended his cross-claim to add Step, Kitchens and GAGE as cross-defendants. Davis' second amended cross-claim added Iseli, Miller and Ganant as

cross-defendants. The third amended cross-claim added Robert Pike and Rutan & Tucker, a law firm.

Prior to the transfer of the cross-claims to California, the court in Oregon entered an order of foreclosure in August of 1985. The original plaintiffs had no further interest or role in this action after that date.

On or about March 29, 1987, respondent Himmelfarb filed a motion for summary judgment. The basis of that motion was that, as a matter of law, the note issued to Davis was not a security and that the federal securities claims should be dismissed. Additionally, Himmelfarb asked the court to dismiss Davis' pendent state claims.

The District Court granted

Himmelfarb's motion for summary judgment in its entirety and held

> "The court concludes that the application of the risk capital test as to the undisputed facts of this case preclude a finding that the transaction at issue is a security." (Pet. App.A15)

In reaching this conclusion, the court made the following finding; (1) Davis' note was a privately negotiated transaction secured by real property uncontradicted testimony indicated that Davis rejected other forms of structuring the deal, (2) the defendant's right to substitute collateral rendered the importance of collateralization of the loan insignificant for the purposes of characterizing the

transaction, (3) the obligation at issue appeared to be a garden variety privately negotiated loan. Davis had unambiguously disclaimed any interest in Empire's Mexico investment and affirmed that Empire's obligation to Davis had no relationship to Empire's success or failure in that venture. (4) Davis looked to the collateral to secure repayment, not to Empire's entrepreneurial efforts. (5) Davis did not view repayment of his note as dependent on the success of any venture of Empire and (6) the circumstances surrounding Davis' deal with Empire belied any and all analogy to a public offering. Davis conducted extensive negotiations and participated actively in determining the structure of the transaction. Moreover, it was Davis who demanded that the note be secured by a lien on real property. Additional uncontroverted testimony suggested that the

payment schedule on the note was set up to accommodate Davis' personal tax considerations. (Pet. App. A9-15)

Finally, the court held that there was no reason to retain jurisdiction over the state causes of action and dismissed them. While noting that the procedural posture of this action rendered the question of the court's subject matter jurisdiction over the remaining claims somewhat complex, the court found that the assertion of jurisdiction was discretionary and after balancing considerations of judicial economy and fairness to the parties, declined to retain the state claims.

Petitioner appealed the entry of summary judgment in favor of respondents to the United States Court of Appeals for the Ninth Circuit. On that appeal, (Danner, et

al. v. Himmelfarb, et al. and related cross-claims) the Ninth Circuit Court of Appeals affirmed the District Court's granting of summary judgment on the ground that the Empire note was not a security and therefore there was no federal securities law subject matter jurisdiction. Additionally, the court affirmed the dismissal of Davis' state law claims.

In affirming summary judgment in favor of respondents, the Court of Appeals held that the context of the underlying transaction was such that it was clear that no "security" was involved and that therefore it was not necessary for the court to apply the "risk capital" test since the question of whether the instrument constituted a "security" was not a close one. (Pet. App. A37.)

Noting that the nature of an

instrument is to be determined at the time of the issuance, not at some subsequent time, the court stated

> "Davis sold an asset in exchange for a promissory note secured by a deed of trust. Davis did not "invest" his money in Empire or Empire's planned Mexican venture. He did not expect "profits" in the sense of either capital appreciation or a share of the earnings from a business venture formed with the borrowed capital. (Citations) Davis did not 'lend' Empire money, except to the extent that any sale of an asset in exchange for a promissory note represents the sellers loan to the buyer of a portion of the purchase price.

> Based on the context of the transaction and its economic realities, we agree with the District Court that Empire's note is not a 'security' for purposes of the Federal Securities Law."

In addressing the question of the dismissal of Davis' state law claims the court held

> "Whether Davis' state law claims are pendent to his federal cross-claim or are ancillary to the original action is irrelevant because, viewed either way, identical considerations lead us to conclude that the court did not abuse its "broad discretion" by dismissing the state law claims. (Pet. App. A51)

Subsequent to the decision of the United States Court of Appeals for the Ninth Circuit, petitioner sought rehearing or rehearing en banc. On December 15th, 1988, the panel unanimously voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The matter now comes before the Court on Davis' Petition of Certiorari to the Ninth Circuit Court of Appeals.

REASONS FOR DENYING THE WRIT

A. The Peculiar Facts Of This Case Do Not Warrant Reexamination Of Federal Securities Law And This Writ Should Be Denied.

Petitioner would have this Court

extend its ruling in Landreth Timber Company v. Landreth, 471 U.S. 681, 105 S.Ct.2297, 85 L.Ed.2d 692 (1985) to the question of whether a note should be deemed a security based solely on its title and characteristics. In Landreth, this Court rejected the sale of business doctrine in relation to the determination of whether stock should be treated as a "security" and held that the particular characteristics of stock made it susceptible to a plain meaning approach in determining whether or not that stock was a "security." In persuasive dicta, this court pointed out several reasons why stock was distinguishable from most, if not all, of the other categories listed in the Acts definition of security.

First, traditional stock "represents to many people both

> trained and untrained in business matters the paradigm of a security." ... Second, as we made clear in Forman, "stock" is relatively easy to identify because it lends itself to consistent definition. (Id. at 693)

On the other hand, the court pointed out that a "note" should be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending upon whether issued in a consumer context, as commercial paper, or in some other investment context. (Landreth Timber Company v. Landreth, supra, at pp. 693-694) Clearly, as the facts of this case highlight, a note is not a category of instruments in the Acts definition that might be shown by proving

only the document itself. Moreover, while holding that "stock" was particularly susceptible to being proved by its characteristics, the court noted that it was still important that the context of the transaction sought to be placed within the scope of the securities laws be examined when deciding whether some financial instrument is a "security". (Landreth Timber Company v. Landreth, supra, at 687) Thus, the court's approach in Landreth did not require the Court of Appeals to ignore the economic realities in the context of the underlying transaction in declining to label Empire's note to Davis as a security.

While respondent acknowledges that the Circuit Courts have used different methods of analysis for determining whether an instrument is a "security", the great majority of cases examine the context of

the transaction in order to determine whether or not the transaction falls within the coverage of Federal Securities law. See United Sports Fishers v. Buffo 597 F.2d 658 660 (9th Cir. 1978; Exchange National Bank of Oregon v. Touche Ross, 546 F.2d 1126, 1137-38 (2d Cir., 1976); Zeller v. Bogue Electric Manufacturing Corporation, 476 F.2d 795, (2d. Cir.,), Cert. denied 414 U.S. 908, 94 S.Ct. 217,38 L.Ed.2d 146 (1973) Leino v. City Investing Company. 487 F.2d 689 (3d Cir., 1973); McClure v. First National Bank of Luvick 497 F.2d 490 (5th Cir., 1974), Cert. denied 420 U.S. 930, 95 Sup.Ct. 1132, 43 L.Ed.2d 402 (1975)

The uncontroverted evidence in this case makes clear that the context of the transaction took it outside the scope of securities regulation. Petitioner sold an asset in exchange for a promissory note

secured by a deed of trust. Petitioner did not "invest" his money in Empire or Empire's planned Mexican venture. He did not expect "profits" in the sense of either capital appreciation or a share of the earnings from a business venture formed with the borrowed capital. Nor did petitioner lend Empire money, except to the extent that any sale of an asset in exchange for a promissory note represents the sellers loan to the buyer of a portion of the purchase price. Whether this transaction is examined under the Ninth Circuit's "risk capital" test or if it is viewed only in the context of the transaction itself, the result is the same, this note was not a security.

Petitioner has shown no good reason why this court should reexamine the holding of the United States Court of Appeals for

the Ninth Circuit and for these reasons respondent respectfully request that this Petition be denied.

B. **Whether The State Claims Are Ancillary Or Pendent, The Decision To Exercise Jurisdiction Remains a Discretionary Function.**

The decision by the Court of Appeals to affirm dismissal of the state claims rests on years of uniform precedent. In United Mine Workers v. Gibbs, 383 U.S. 715 (1966), this Court formulated a framework for the analysis of factors that a court should consider before retaining jurisdiction over non-federal claims. The suit in Gibbs involved a state claim of malicious interference with contract appendant to a federal, secondary boycott claim. The test that the court enunciated

was that

> "... If, considered without regard to their federal or state character, a plaintiff's claims are such that he would ordinarily be expected to bring them all in one judicial proceeding, then, assuming the substantiality of the federal issues, there is power in the Federal Courts to hear the whole. (Id., at 725 (Citations omitted). However, this court noted "... pendent jurisdiction is a doctrine of discretion, not of plaintiff's right. Its justification lies in consideration of judicial economy, convenience and fairness to litigants; if these are not present a Federal Court should

hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them ..." Id. at 726 (fn. and citation omitted).

The District Courts have applied the analysis developed in Gibbs, a pendent jurisdiction case, to suits like the present case that raise questions about the retention of ancillary jurisdiction after dismissal of the federal claims. See, e.g., Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 458 (7th Cir. 1982), Cert. denied, 459 U.S. 880; Waste Systems, Inc. v. Clean Land, Air and Water Corporation, 683 F.2d 927 (5th Cir. 1982), United States v. Zima, 766 F.2d 1153 (7th Cir., 1985).

Moreover, the Federal Appeals Courts in general have indicated a strong

preference for the dismissal of pendent or ancillary claims whenever the District Court disposes of the federal claim or claims prior to trial. Indeed, in cases involving complex or novel issues of state law, the appellate courts have held that it is an abuse of discretion to retain jurisdiction after the federal issue is disposed of at trial or even on appeal. See, e.g., Federman v. Empire Fire & Marine Insurance Company, 597 F.2d 798, 811 (2d Cir. 1979); Hodge v. Mountain State Telephone & Telegraph Company, 555 F.2d 254 (9th Cir. 1977); American National Bank & Trust Co. v. Bailey, 750 F.2d 577, 581 (7th Cir. 1984).

It is therefore clear that whether these claims are viewed as pendent or ancillary makes no difference to the determination of whether or not the court

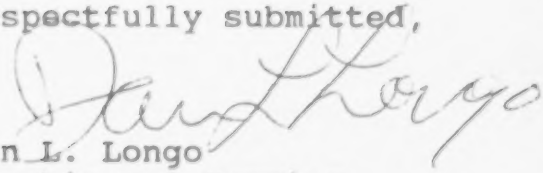
should have retained jurisdiction over the state claims. As the Court of Appeals for the Ninth Circuit pointed out, the decision to exercise jurisdiction is always discretionary. The trial court properly examined the relevant factors and determined that, on balance, it should exercise its discretion and decline to retain the state claims. (Pet. App. A58-59) Petitioner has shown no good reason why this court should reexamine the decision of the Court of Appeals for the Ninth Circuit nor has petitioner showed a gross deviation from the guidelines enunciated by this court in United Mine Workers v. Gibbs. For these reasons, the Petition for Writ should be denied.

CONCLUSION

No matter how many different tests under which this transaction is examined, the fact remains that in the particular circumstances and context of this transaction, the note in question was not a security. Nothing in the particular facts of this case warrants uprooting this decision. Moreover, following the decision of this Court in United Mine Workers v. Gibbs, the lower courts have uniformly held that the decision whether to retain jurisdiction over pendent or ancillary claims is a matter left to the sound discretion of the trial court. Again, nothing in the peculiar facts of this case warrant uprooting this time honored rule.

For the foregoing reasons, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,



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